BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)
	)
VALLEY VIEW SANITARIUM AND REST HOME, INC.	)
	)

Appearances:

For Appellant: Robert W. Acheson
Certified Public Accountant

For Respondent: Paul J. Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to sections 25761a and 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Valley View Sanitarium and Rest Home, Inc., for reassessment of a jeopardy assessment of franchise tax and penalty in the total amount of $5,472.83 for the income year 1969.

The issues presented are: (1) whether appellant is entitled to deduct a bad debt loss in the amount of $68,500,. or any lesser amount; and (2) whether a penalty for failure to file a timely tax return was properly applied.

Appellant is a California corporation, incorporated on June 1, 1949. Its principal business is the operation of a sanitariumand rest home. On November 1, 1968, Mattie Cheneweth owned 50 percent of appellant's stock. Her sons, Charles, James and Leland each had a one-sixth shareholding interest.

On November 21, 1968, Charles, in consideration of a $48,500 loan, transferred his one-sixth shareholding interest in appellant to his mother. The stock was transferred as security for the loan. On the same date Charles borrowed an additional $20,000 from appellant, giving in exchange an interest-bearing promissory note secured.by a deed of trust on specified real property.

Charles, who had extensive business interests in addition to his interest in appellant, encountered serious financial difficulties in his business affairs. During 1969, however, he did repay $5,946 to appellant. Because of the business and financial setbacks, and ill health partly caused by the trauma of impending bankruptcy, he ceased doing business on March 31, 1969.

On September 17, 1969, Charles filed a petition in bankruptcy and was adjudged bankrupt that year. With his petition, he listed unsecured creditor's claims totalling more than $2,275,000. 1/ Included among the names of unsecured creditors were Mattie and appellant: The first meeting of creditors was held October 7, 1969. Creditors were required to file their claims with the referee in bankruptcy on or before April 7, 1970. Charles received his discharge in bankruptcy on August 24, 1970. Appellant recovered nothing from the bankruptcy estate.

1/ Moreover, Charles was apparently otherwise heavily indebted in 1969 because of overpayments received by him under the Medicare and Medi-Cal programs in connection with his various enterprises;

Appellant foreclosed on the real property securing the $20,000 loan on July 7, 1970. Inglewood Thrift and Loan Company of Inglewood, California, purchased the property at the trustee sale for $43,000, the amount that was owed by Charles to Curtis-Coleman Company, another of his creditors, which held a first trust deed on the property. Thus, no money was received by appellant as a consequence of the sale.

The stock of appellant owned by Charles that he transferred as security to his mother for the other $48,500 loan had a book value of $6,907 on December 31, 1969.

On its 1969 franchise tax return, appellant deducted $62,554 as a bad debt loss. This amount is the difference between $68,500 (the total amount borrowed on November 21, 1968) and $5,946 (the amount repaid to appellant in 1969). 2/ Appellant filed its tax return for the income year 1969 on September 17, 1971. Payment of the amount shown due on the return, however, was not received by respondent until February 14, 1973.

Appellant was suspended on February 1, 1972. Subsequently, respondent issued a jeopardy assessment as a result of the disallowance of the claimed bad debt deduction. Respondent also added a 25 percent penalty because of the untimely return and payment for the year 1969. Appellant was revived upon payment of the tax disclosed on the 1969 return. It timely petitioned for reassessment. The assessment was affirmed and this appeal followed.

Revenue and Taxation Code section 24348 allows a deduction for "debts which become worthless within the income year." It also provides that "[w]hen satisfied that a debt is recoverable in part only the Franchise Tax Board may allow such debt, in an amount not in excess of the part charged off within the income year, as a deduction.". This section is the counterpart of section

2/ Appellant now concedes that the bad debt loss should be reduced to $55,647. This amount represents the sum deducted ($62,554) less the book value ($6,907) of appellant's stock pledged with Mattie by Charles.

166 of the Internal Revenue Code of 1954. Turning to the question of the deductibility of the $48,500 debt, we note that a bona fide debt, for purposes of section 24348, must he a debt which arises from a debtor-creditor relationship. (Cal. Admin. Code, tit. 18, § 24348(d), subd. (3); see Treas. Reg. § 1.166.1(c).) Appellant contends that appellant, not Mrs. Cheneweth, actually made the $48,500 loan in 1968 to Charles. It is claimed that the funds in question were not obtained by Mattie but by appellant and that appellant is still repaying the persons who provided it with the funds. It is' also maintained that over a period of years prior to 1969, appellant had advanced sums to Charles, including the $48,500 loan. It is urged that it was merely an oversight that the stock was pledged to Mrs. Cheneweth.

Notwithstanding these allegations, we are unable to conclude that the $48,500 loan was made by appellant. There is no evidence in the'record indicating that the $48,500 advance was made by the taxpayer corporation to Charles. The only evidence offered pertaining to this loan was the transfer agreement of November 21, 1968, signed by Charles. It is provided therein that, "it is agreed by Mattie I. Cheneweth and Charles I. Cheneweth -that in consideration for Mattie I. Cheneweth obtaining a loan for ($48,500.00)... for me, that I, Charles I. Cheneweth, do hereby transfer tc her my one-sixth interest in [appellant] .... Mattie I. Cheneweth agrees that upon my repayment of the loan she will transfer said shares back to me. In the event that I am unable to repay my part of that'loan, I hereby relinquish all rights and claim and ownership in said stock to Mattie I. Cheneweth."

The language in that document indicates that the loan was made by Mrs. Cheneweth to Charles, whether or not she acquired the funds from appellant. Thus, the record before us establishes, with respect to the $48,500 debt, that the debtor-creditor relationship was between Mattie and Charles. Since'the loan was not made by appellant to Charles, any bad debt loss resulting from the loan would not be deductible by appellant.

We must next determine whether the unrecovered portion of the $20,000 loan ($14,054) made by appellant to Charles, evidenced by the interest-bearing note and secured by a deed of trust became totally worthless or partially worthless in 1969. It is the taxpayer who must carry the burden of proof. (Cittadini v. Commissioner,

139 F.2d 29 (4th Cir. 1943).) In order to be entitled to the deduction set forth in section 24348 of the Revenue and Taxation Code, the taxpayer must prove that the debt became worthless in the year claimed. (Redman v. Commissioner, 155 F.2d 319; (1st Cir. 1946); Appeal of Grace Bros. Brewing Co., Cal. St. Bd. of Equal.., June 28, 1966.) The standard for the determination of worthlessness is an objective test of actual worthlessness. The time of actual worthlessness must be fixed by an identifiable event or events which furnish a reasonable basis for abandoning any hope of future recovery. (United States v. White Dental Manufacturing Co., 294 U.S. 398 [71 L. Ed. 1120)] (1927); Appeal of Morlyn L. Brown, Cal. St. Rd. of Equal., Oct. 27, 1964.)

Appellant has introduced evidence indicating that in 1969 Charles filed a petition in bankruptcy, was heavily indebted, and was adjudicated a bankrupt. The debt in question was secured by a deed of trust. As already indicated, the courts have required that the taxpayer must establish worthlessness by some identifiable event or events in order to justify the deduction of losses resulting from bad debts. A secured debt does not become totally worthless until the collateral security itself becomes worthless. (See Loewi v. Ryan, 229 F.2d 627 (2d Cir. 1956); Appeal of Morlyn L. Brown, supra.) The only clearly identifiable events that established the total worthlessness of the remaining balance of the $20,000 loan occurred in 1970 when no proceeds were received by appellant notwithstanding the sale of the real property securing the loan and notwithstanding Charles' discharge in bankruptcy. Consequently, the debt could not be regarded as totally worthless in 1969.

Section 24'348 also provides for an allowance for partial worthlessness. Here, however, there is no basis for allowing a deduction for partial worthlessness in 1969. Appellant has simply not proved that the unrecovered portion of the $20,000 loan ($14,054) was partially worthless in 1969.

Appellant has not presented any argument in opposition to the imposition of the penalty for failure to file a timely return. Appellant's return for the income year 1969 was due on March 15, 1970, but not filed until September 17, 1971. No extension of time in which to file a return had been obtained. The penalty is applicable "unless it is shown that the failure [to file] is due to reasonable cause and not due to willful neglect." (Rev. & Tax. Code, § 25931.) The burden of proof is upon

the taxpayer. (Appeal of Citicorp Leasing, Inc., Cal. St. Bd. of Equal., Jan. 6, 1976; Appeal of Electrochimica Corp., Cal. St. Rd. of Equal., Aug. 3, 1970.) Consequently, must assume that the penalty applies.

For the foregoing reasons, respondent's action in disallowing the bad debt deduction and in imposing the penalty is sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of Valley View Sanitarium and Rest Home, Inc., for reassessment of a jeopardy assessment of franchise tax and penalty in the total amount of $5,472.83 for the income year 1969, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of September 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member